Remarks by
Tim Long
Senior Deputy Comptroller for Bank Supervision Policy and
Chief National Bank Examiner
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Thank you and good morning. It's a pleasure to be here today.

Let me begin by stating the obvious. These are challenging times -- for all of us. As regulators, our challenges include overseeing a financial system that is still emerging from the recent financial crisis while also implementing the massive changes called for in the Dodd-Frank legislation. The regulatory structure is itself about to undergo sweeping changes, with the elimination of the Office of Thrift Supervision, the creation of the Bureau of Consumer Financial Protection, the advent of the new Financial Stability Oversight Council, and much more. At the same time, the new law assigns the agencies responsibility for writing dozens, if not hundreds, of new rules that will affect the industry in some ways we can hardly foresee, and for doing it within some extremely aggressive timeframes.

For many of you here the task is equally, if not more, challenging. In addition to continuing to work through elevated problem asset levels, bank management teams, boards of directors and auditors will have to deal with a host of regulatory and accounting changes that have the potential to affect the business models of financial institutions in profound ways.

All the uncertainty about how traditional business practices will work in the new regulatory world, such as how to market, how to book, and how to price various products is, of course, deeply unsettling to financial institutions. We understand that, and, take seriously the need for regulators and accounting standard-setters to move as quickly as possible to give the industry the clarity it needs to move ahead, at a time when a strong and competitive financial sector is more important than ever to our economy.

But we have to be smart, as well as quick, about it. The rules we adopt are rules the industry is going to have to live by for years. So we need to think very carefully about how these rules are going to affect the business models of this country's banks before we adopt them. The process of formulating and implementing the regulations surrounding Dodd – Frank will test our capabilities to practice good government and to be inclusive, deliberate, and transparent. We have to be careful to avoid unintended consequences being imposed on the industry -- and trust me, in any bill this big and complex, the potential for unintended consequences is enormous.

This process must also be informed by the perspective of the recent past, which I believe offers invaluable insights we can and should use as we implement Dodd-Frank and various other regulatory and policy initiatives. I'd like to share a few of those insights with you today.

There's been no shortage of books, articles, and speeches from people claiming to know why the financial crisis happened and what we need to do to make sure it doesn't happen again. But, helpful as much of this analysis is, I'm struck by how often the analysts miss a crucial point. The causes of this financial crisis were remarkably similar to those we've seen in past crises. Regulators, bankers, auditors, and accounting standard-setters -- we all lost sight of some of the most fundamental concepts of banking. We allowed credit underwriting standards to be compromised. We tolerated excessive levels of leverage. We permitted concentrations to build to dangerous levels. Finally, we did not recognize, or did not take sufficient actions to arrest, imprudent growth.

As we work through Dodd-Frank, it's more important than ever that all of us – regulators, bankers, auditors, and accounting standard-setters -- refocus on the fundamentals of sound banking I've just mentioned. At the OCC, we are doing just that.

Well before he left the Comptroller's office, John Dugan took the lead in calling for the restoration of strong mortgage underwriting standards and putting an end to the now-discredited practice of waiving borrower documentation requirements. Our suggestions for mortgage reform led to others, including minimum floors for down payments, maximum loan-to-value ratios, and limits on debt to income. All of these ideas – ideas that would undoubtedly have been non-starters just a few years earlier – were under serious interagency discussion even before Dodd-Frank became law. Formulating standards for residential mortgage underwriting under the risk retention provisions of section 941 is one of the OCC's highest priorities and I expect that our work will draw heavily from some of these earlier discussions.

The second issue we should reflect on is the massive buildup of commercial real estate concentrations on community bank balance sheets. With hindsight, it is clear that we and the other regulators did not move quickly or aggressively enough to curtail the build-up of non-residential mortgages and construction loans that had so much to do with the nearly 300 banks that have failed since 2007. Of course, banks fail for many reasons, and not all of them are within the control of bank supervisors. But it is clear to me that the OCC and other supervisors should have been more direct and aggressive in addressing commercial real estate concentrations. While I think we all knew better, we –

and here I mean regulators, auditors, *and* bankers -- talked ourselves into believing that robust risk-management systems could compensate for many such concentrations, even when they were above the supervisory thresholds described in the 2006 guidance. Yet, even though the 2006 interagency guidance that the OCC initiated was a relatively modest response to what was clearly a growing problem, it was still met with intense opposition from much of the industry.

I think the time has come where the regulators really do need to come to grips with concentration risk management. We need to do a much better job of articulating our expectations to you in the industry and defining what we consider to be strong risk management practices. Because the fact is, if an institution is going to take a large concentration in commercial real estate, <u>strong</u> risk management practices, as opposed to simply <u>satisfactory</u> risk management practices, should be the minimum required.

I also think the time has come to set some parameters for concentration limits in commercial real estate lending for financial institutions, particularly community banks. I'm thinking here in terms of specific capital expectations for correlated exposures over certain limits, such that as a bank's concentrations increase, so too would the buffer above regulatory capital minimums that they would be expected to maintain. This would provide more formality and transparency to the agencies' longstanding policy that our risk-based capital standards represent minimum capital levels and that most banks need to maintain capital levels above those thresholds. The OCC, for some time, has been applying this policy through our authority to establish what we refer to as Individual Minimum Capital Requirements, or IMCRs. Through this tool, we can more formally articulate our requirements and expectations for a bank's capital level based on its specific facts and circumstances. We intend to continue to make use of IMCRs, especially where we see significant concentrations. While the flexibility of this tool is important, I also think we probably need to provide more guidance and bright lines on how we apply it to ensure greater consistency and transparency.

I have been speaking to you frankly about what we have learned from the financial crisis and how those lessons can help bank regulators do their jobs better in the future. So I'm going to be equally candid in turning to another issue whose importance was highlighted during the financial crisis. I'm referring to the allowance for loan losses. Regulators, auditors, and accounting standard-setters have been struggling with this issue for a long time now, and quite unproductively, in my opinion. I think it's time to press the reset button and clear away the apparent confusion over what accounting rules do and do not allow and what qualitative, or "Q," factor judgments are required to estimate credit losses by credit administration personnel with review by examiners.

One of the most striking sidebars in the story of the financial crisis is the unprecedented speed with which once well-capitalized institutions succumbed to their credit losses. One reason for this is that banks held historically low levels of loan-loss reserves coming into the current recession. Some critics have tried to shift blame for the shortfall to examiners, suggesting that they should have required banks to make additions to the allowance when it became clear that credit troubles were on the horizon. Perhaps there were situations in which we didn't push hard enough to build reserves, although that would be entirely out of character for the examiners I know and manage. The fact is that examiners found themselves limited by existing accounting rules. Those rules and the way they were applied made it impossible for banks to reserve for losses that I believe could be reasonably anticipated. The result was that when subsequent charge-offs on impaired assets did occur, the reserves were not there to support them, and higher provision levels reduced capital. That accelerated the spiral into insolvency for many financial institutions.

There's growing agreement that rigid adherence to the "incurred loss" model had unfortunate consequences:

- It delayed reserve-building for losses when there was a strong belief that those anticipated losses were going to occur.
- It magnified the effect of those losses when they did occur.
- It undermined public confidence in the financial system and amplified negative pressures on the global economy.

This is not just my view; it was also the conclusion of the Financial Stability Board's Working Group on Provisioning.

I believe we have made the provisioning for loan losses much too complicated for the industry, for our examiners, and for auditors. Whether we adopt the expected loss model or something else, we need to get back to a fundamental understanding about the loan loss reserve and what it's meant to represent. Somehow, we've allowed accounting doctrine and the accounting profession to encroach on what is fundamentally a process of credit estimation, based on credit administration inputs. Credit factors such as problem loan identification, loan classification criteria, and nonaccrual and charge-off recognition, are all judgments that should be made by the people best able to speak to the bank's overall credit risk exposure: its senior managers and its credit administration and credit risk professionals, with oversight by its prudential supervisors.

I will grant you that some of the bankers that I supervise did a poor job of documenting their reasoning when building their reserves. But I think some in the bank accounting profession placed too much reliance on the lack of historical loss rates and missed the resulting build up of credit risk on the banks' balance sheet.

Think about this. We were coming off 15 years of an incredibly favorable credit cycle and a very benign loss history. We witnessed some of the most liberal underwriting practices and asset concentration build up we have ever experienced in this country. Those factors -- loosening underwriting standards and growing concentrations -- should have been sufficient evidence of the need for building reserves for the increased risk everyone was seeing on the balance sheets of our banks. But the evidence was largely pushed aside. Simply put, our accounting doctrines did not let bankers do what many knew was instinctively right, and that was to increase their reserve builds.

So while I will grant you that my examiners may have at times not required the level of documentation an accountant would expect for a well funded reserve, I think my examiners got the reserve analysis generally right and the auditors got it precisely wrong. A lot of judgment is required when assigning qualitative factors to the allowance. When underwriting becomes too liberal, growth and leverage become excessive, and risk accumulates in bank balance sheets, there is plenty of room for judgment by credit administration personnel to build their reserves during these times. If there is increased risk in the loan portfolio, the allowance should be permitted to reflect it.

Now, on the flip side of the credit cycle, banks are coming under pressure from their auditors to <u>reduce</u> their reserves on the grounds that an improving economy has increased the collectability of their loans. Never mind that a double-dip recession is hardly out of the question. That's why so many financial institutions are uncomfortable with the idea of releasing reserves – and why it's so important for regulators, bankers, and auditors to exercise restraint and not let the industry prematurely release reserves or run their allowance balances to an unrealistic low level.

This brings me to the last point I want to cover today. Dodd-Frank has changed the regulatory landscape in ways that will require more collaboration and coordination between and among various regulators, audit professionals, economists and quantitative experts. But this inclusiveness must not be at the expense of the insights that on-the-ground supervisors bring.

We've seen how important real-world perspective can be in formulating financial regulatory policy. That perspective made all the difference in the world during our S-CAP, or stress test, exercise, which took place during the worst days of the market disruption. It's easy to forget how precarious the situation was when S-CAP occurred only 18 months ago. Liquidity had vanished even for some rock-solid institutions; wholesale nationalization of the financial system was under serious discussion; and there was a pervasive sense of fear that this was a crisis too big for government, for anyone, to handle.

S-CAP marked a critical turning point in the financial crisis. The markets judged the regulators' scenarios to be credible, and, with solid evidence that the large U.S. banks were strong enough to withstand the worst that the economy might reasonably throw at them, liquidity slowly returned and the markets stabilized. History will judge the S-CAP exercise to be a huge success, and I'm not about to argue with that judgment.

Yet in retrospect, it's clear that the margin between success and failure was a thin one. Now, at a time when banks are significantly outperforming the S-CAP severe stress projections, it's easy to forget the intensity of the discussion that took place in regulatory circles over whether the stress numbers were high enough. Some of the non-supervisory personnel who helped design the S-CAP argued that those severe stress numbers were much too low and were more of a probable estimate than a severe stress. In fact, as we've seen over time, the scenarios they were proposing vastly exaggerated bank losses and underestimated their earnings.

Fortunately, a more realistic view prevailed. And that was in large part because we also made sure to have supervisory people sitting at the table -- people who worked in the banks and the regulatory agencies, who had been through previous banking crises, who had the knowledge to speak first hand about conditions on the ground and in the institutions whose survival was at stake. They lent realism and credibility to the analysis. Their judgment and experience played a crucial role in getting the numbers right, at a time when the right numbers were all-important.

The history of S-CAP, I believe, provides another reminder that good financial policy cannot be shaped in a vacuum. Economic analysis and modeling will always be essential tools in supervising our financial system. But they are only tools, and they are only as good as the people who use them. And in bank supervision, as in most things, experience and judgment are vital to success.

Thank you.